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February 11, 2003

The Honorable Janet Napolitano
Governor of the State of Arizona,
Members of the Legislature, Chief Justice of
the Supreme Court and Citizens and Taxpayers
of the State of Arizona

Ladies and Gentlemen:

It is our pleasure to transmit to you the Comprehensive Annual Financial Report (CAFR) of the State of Arizona for the fiscal year ended June 30, 2002. The CAFR has been presented in conformance with the Governmental Accounting Standards Board (GASB) statements 34 and 35. The objective of this new reporting model is to provide a clear picture of the government as a single, unified entity as well as providing traditional fund-based financial statements.

Responsibility for the accuracy of data, completeness and fairness of presentation, including all disclosures, rests with the State's management. The data presented in this report, to the best of our knowledge and belief, is accurate in all material respects and is reported in a manner which fairly presents the financial position and results of operations of the major and non-major funds of the State. All disclosures needed for the reader to gain a reasonable understanding of the State's financial activities have been included.

The report is presented in three sections: Introductory, Financial and Statistical.

The **Introductory Section** includes this Letter of Transmittal, the State's organizational chart and a list of principal State officials.

The **Financial Section** includes the State Auditor General's independent auditors' report, Management's Discussion and Analysis (MD&A) and the basic financial statements (which include the government-wide financial statements, the fund financial statements and the notes to the financial statements). The financial section also includes Required Supplementary Information (RSI), which includes budgetary comparison schedules, infrastructure condition and maintenance data, and retirement plans funding progress. In addition, the financial section includes other supplemental financial data, which includes combining financial statements.

The **Statistical Section** includes selected financial, economic, and demographic data.

Generally accepted accounting principles require that management provides a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of the MD&A. This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The State's MD&A can be found immediately following the independent auditors' report.

FINANCIAL REPORTING ENTITY

The accompanying CAFR includes all funds of the State of Arizona (primary government), as well as its component units. Component units are legally separate entities for which the primary government is financially accountable.

Discretely presented component units are reported in a separate column in the government-wide financial statements to emphasize that they are legally separate from the primary government and to differentiate their financial position and results of operations from those of the primary government.

The criteria for inclusion in the reporting entity and its presentation are defined by the Codification of Governmental Accounting and Financial Reporting

Standards, issued by the Governmental Accounting Standards Board, (Section 2100). Note 1.B of the Notes to the Financial Statements explains which units are included in the Financial Reporting Entity of the State.

ECONOMIC CONDITION AND OUTLOOK

The following economic summary, is excerpted from the Arizona Department of Economic Security's Arizona's Workforce, August 29, 2002.

A little more than two-and-a-half years into this bold new millennium, "irrational exuberance" has been starkly replaced by goals focused on profitability instead of promises, pressures of financial prudence and accountability, and realistic rather than speculative business models. Many bold, aggressive companies once deemed high achievers have been rendered "bottomed out" and their business models and goals discarded, respectfully, as obsolete and misguided. It seems we are humbled to realizing that the new millennium is as real as it ever was. In retrospect, it all seems all so clear, and so we go forward.

During this time of near euphoric optimism and growth, Arizona's economy charged into the new millennium with great zeal. As one of the fastest job growing states in 2000, Arizona faced such economic pressures as how to find enough workers to meet business demand. It was poignant enough to capture the attention of Lenita Jacob-Simmons, Deputy Assistant Secretary of Employment and Training with the U.S Department of Labor, who flew to Arizona to discuss some of the major issues of a fast-growing economy confronting the State. Just two years ago, for example, Phoenix-Mesa and Tucson MSAs (metropolitan statistical areas) were showing incredibly low unemployment rates of about 2.6 percent.

The most recent (July) jobless figures, however, show the Phoenix-Mesa MSA at 5.4 percent and Tucson at 4.7 percent. Additionally, Arizona's businesses slowed job growth from an annual average of nearly 4 percent in 2000 to only 1 percent in 2001. Moreover, Arizona's economy is expected to slow even further in 2002. The Arizona Department of Economic Security, Research Administration (RA) expects a loss of almost 1 percent of jobs for 2002 in its 2002-03 employment forecast update.

After 20 years of employment growth, represented by growth of more than 1,215,000 non-farm jobs, Arizona is expected to show a loss of nearly 21,000 jobs in 2002. A modest economic upturn is expected to begin building momentum in the second half of 2002 and into the following year, with jobs growing at an annual average pace of almost 2 percent in 2003. This represents a gain of almost 40,000 jobs in 2003. Thus, RA's forecast update sees Arizona's businesses adding slightly more than 19,000 jobs over the two-year period.

Generally, the major difference with this forecast update and RA's March forecast is that Arizona's economy has continued to slow in 2002, slightly more than earlier expected, and it seems clearer now that 2003 will not likely recover as fast or robustly as earlier predicted. This economic recovery job growth is one in which businesses are expected (by shareholders, investors, and responsible management) to be very deliberate, yet cautious, while working through these slower, difficult times toward profitability.

Arizona's goods-producing industries are anticipated to shed nearly 23,000 jobs over the 2002-03 period. Meanwhile, service-producing industries are projected to add slightly more than 42,000 jobs.

Recent figures for manufacturing have only hinted at the industry leveling off from the losses that began nearly two years ago. However, announcements made this week suggest additional layoffs may yet come in the near future as national and global manufacturing companies continue to grapple with costs and projections of slower demand. RA expects manufacturing jobs will decline by more than 12,000 over the two-year forecast horizon. Most of these losses are expected in 2002 as the industry pares down nearly 6 percent of its workforce. The forecast for 2003 is for some improvement, as levels simply remain flat.

Fueled with low interest rate financing and relatively vibrant demand for housing, Arizona's construction industry has endured a decade of strong growth. Between 1991 and 2001, annual average figures show that Arizona's economy added more than 87,000 construction jobs. RA's forecast calls for a slow decline of 9,500 construction jobs over the two-year period. About 80 percent of these losses are anticipated to occur in 2002.

Mining is forecast to lose 1,000 jobs, nearly an 11 percent industry decline in employment. As earlier cited, extended downward pressure on this industry is expected beyond 2003.

Arizona's trade industry is forecast to add 17,000 jobs in the 2002-03 period. Despite being a rough year for consumers who dealt with unrelenting news of corporate scandals, job losses, and terrorist threats, they kept spending. However, as the events of the year proceeded, it was becoming clearer that consumers were growing increasingly concerned. Additionally, Arizona's economy was dealt a series of economic blows as the drought sharply curtailed winter and summer activity in trade and services (of which many are tourism industries). This only worsened as fires ravaged several areas of the State, resulting in park closures and the loss of homes and businesses. And if all that wasn't bad enough, weather forecasts into this coming 2002-03 season strongly suggest another drought-stricken period awaits. In all, RA's forecast calls for an increase of slightly more than 2,000 trade jobs in 2002 and nearly 15,000 in 2003.

Services is another industry largely affected by tourism, but as well by business activity. One of the most devastated of sectors has been that of hotels and lodging. Not only was the slowing economy braking employment growth, the events that followed the September 11th terrorist attacks crippled consumer travel. As earlier mentioned, all of this was adversely compounded with the drought, fires, and park closures. This comes especially hard to an industry that, for several earlier years, invested in remodeling, expansions, and building new facilities across the State. One sector that remains strong through the forecast horizon is health services. It is one of the fastest job-growing sectors.

Services is forecast to shed 5,000 jobs in 2002 and gain slightly more than 14,000 in 2003. Thus, for the 2002-03 forecast period, better than 9,000 jobs are expected.

The transportation, communications, and public utilities group is forecast to lose more than 4,000 jobs in the two-year period. Job losses are expected in 2002, with a slight improvement of modest gains in 2003. Transportation and communication sectors are expected to face continued pressure to control costs in the wake of retracted or, at best, tepid demand. Airlines, through competitive pricing, have struggled to achieve profitability, but it hasn't come easily. Public utility jobs have been fueled by the relative strong growth in the State's population and housing development.

Arizona's finance, insurance, and real estate group is forecast to show a slight loss of nearly 1,000 jobs. A slight increase of nearly 1,500 jobs is forecast for 2003, or growth of about 1 percent. Financial sectors have been digesting the increased risks that often come with a slowing economy. As well, financial and investment sectors are grappling with controlling their own costs amidst public scrutiny and scorn. As reported by the latest figures from the American Bankruptcy Institute, bankruptcies in Arizona achieved a record level in 2001 and the trends through the second quarter of 2002 are not looking better. Real estate buying and investment has spurred mortgage financing and re-financing, but this also comes with consumers struggling to consolidate debt.

In conclusion, Arizona's economy has continued to weaken in 2002. While RA's earlier forecast showed similar trends of a loss of jobs in 2002 and a recovery in 2003, this update has reasoned a more modest economic recovery in 2003 is likely to follow the slightly increased layoffs of 2002.

MAJOR INITIATIVES

Tax Policy. Laws 2001, Chapter 2 adjusted the State's withholding rates to compensate for changes at the federal level and created an amnesty program for vehicle title registration and individual income taxes. Arizona withholding rates are tied to the federal withholding rates, which were due to change on January 1, 2002. The reduction to the federal rates would have changed the timing of Arizona collections and would have meant a one-time impact of decreasing FY 2002 revenues by approximately $60 million had the Legislature not acted.

The amnesty period established by Laws 2001, Chapter 2 ran from January 1, 2002 until March 31, 2002 for vehicle title and registration taxes and fees. During this period, no penalties or interest would be charged. The program was estimated to yield approximately $6 million in FY 2002. The law also established a tax amnesty program for any taxpayer with an outstanding individual income tax liability prior to November 1, 2000. The program eliminated penalties due on any past due tax liability; however, interest charges would still be applied. Estimates predict a gain in revenue of approximately $10 million per year for FY 2002 and FY 2003.

Laws 2002, Chapter 50 eliminates the corporate income tax subtraction for dividends received from Arizona corporations. In 1973, the Legislature enacted a corporate and individual subtraction for dividends received from corporations that do the principle portion of their business in Arizona. This law continued to exist in the individual income tax statutes until 1990 when it was repealed as part of the massive rewrite of those laws. However, it continued to exist as a subtraction in the corporate income tax statute. An estimated $22 million revenue gain will be generated.

The other tax change relates to previous Truth in Taxation provisions. Pursuant to the law, the qualifying tax rate is reduced annually to account for the statewide appreciation of existing property. The effect of reducing the qualifying tax rate is estimated to be $38.3 million in 2002 and $25.3 million in 2003.

Health and Welfare. The phase-in of Proposition 204, which expanded AHCCCS eligibility to 100% of the federal poverty level, was completed in FY 2002. The caseload growth was immediate; during FY 2002 Proposition 204 related caseloads grew 200%. Traditional Medicaid caseloads also experienced rapid growth in FY 2002, increasing 21% during the year. The Administration and AHCCCS negotiated a second waiver with the Federal government, which provides enhanced federal participation for a specific segment of the Proposition 204 population. This second waiver also requires the expansion of health care coverage to the parents of KidsCare participants. As a result of the growth of these entitlement programs, all funds from the Tobacco Settlement, Budget Neutrality Compliance Fund, and Medical Services Stabilization Fund were exhausted. This resulted in the requirement to transfer from the General Fund and other Funds to support the program.

With respect to behavioral health, numerous accomplishments were achieved during FY 2002. The State celebrated the grand opening of the juvenile and civil portions of the State Hospital, a modern archetype that reflects a homelike, neighborhood environment. Expenditures from the Serious Mental Illness fund were catalysts for significant improvements in housing and vocational and educational training. Additional Title XIX services, such as particular room and board services, which were not previously federally reimbursable, were negotiated into the new capitation rates in order to free up state-only funding for other requirements. A $19.6 million Title XIX supplemental for behavioral health generated a total of $57.6 million when combined with federal funds.

Education. *K-12 Education* – In FY 2002, K-12 education continued to comprise the largest component of the State's budget. In FY 2002, the State's obligation to fund public schools totaled $2.3 billion. In addition, $232 million was distributed through the Homeowner's Rebate program and 1% constitutional cap (known as "Additional State Aid"), which subsidizes local property taxes assessed by school districts for maintenance and operations of public schools. Aside from these entitlement programs, approximately $57 million in discretionary grants were allocated to Arizona public schools and $24 million in special education funding was provided to public institutions such as the Arizona School for the Deaf and the Blind and children housed in the Arizona State Hospital and residential placements.

In November 2000, Arizona voters approved Proposition 301 that provided much needed financial resources to Arizona elementary and secondary public schools. Through a dedicated funding source, consisting of a 6/10th of a percent increase in the transaction privilege tax, school districts and charter schools recognized additional funding for increased school days, school safety, character education, and school accountability programs. In its first year of implementation, $439 million in FY 2002 dedicated tax revenue was collected and allocated to higher education and K-12 schools. Of this amount, $251 million, or $260 per pupil, was distributed to school districts and charter schools specifically for teacher base and performance pay increases and supplementary funding for maintenance and operations of schools. In addition to the financial windfall, AZLearns, the State's comprehensive academic accountability program, went into effect.

While the significant fiscal impacts of the *Flores v. State* lawsuit were not fully realized in FY 2002, it is important to note the legislation to remedy the lawsuit was enacted. To meet the Court's demands, the Legislature committed over $45 million in FY 2003 to support supplementary funding for non-English speaking pupils.

School Construction – As part of Proposition 301, the voters also authorized up to $800 million in revenue bonding authority to cover the estimated $1.2 billion cost of correcting school building deficiencies as required by Students FIRST legislation. Of this amount, $500 million in bonds were issued in May 2001, and in August 2002, the remaining $300 million were issued to positive investor response. Arizona law requires that all deficiencies in existing public school buildings (excluding public charter schools) be corrected prior to July 2004. As of June 2002, 35% of all deficiencies corrections projects (6,103 in total) were under construction or complete. Although in FY 2002 new school construction was still financed on a cash-basis, new legislation passed that established the lease purchase program, a new long-term financing scheme for new school construction. Approximately $400 million in lease purchase agreements were authorized for FY 2003 and FY 2004.

Finally, the State Land Department had another record year for State Trust land revenues in many areas. The Sales Section held 28 successful land sale auctions for a total of $128 million. The Department also generated a record $35 million in expendable revenue that was sent to the beneficiaries, mainly education, for their immediate use. In total, $153 million was generated by the Trust in FY 2002.

Public Safety. The mission to "protect and serve" continues to be a priority to the Executive to ensure that government has the resources necessary to provide for the safety of citizens of Arizona. With respect to the safety of our highways, the Department of Public Safety (DPS) continues to experience an increase in traffic and accidents on state highways. To handle some of the increases, the Legislature passed Laws 2001, Chapter 1 enabling DPS to hire 116 additional officers, replace 200 patrol cars and increase officer overtime pay in FY 2002 and FY 2003.

Of additional interest, DNA testing was expanded in January 2002 to include all felons convicted of offenses involving the use of a deadly weapon or the infliction of serious physical injury. Laws 2002, Chapter 226 expands the list of offenses requiring DNA testing to include all felony drug offenses in January 2003, and to include all felonies in January 2004. To support this endeavor, an additional 3% surcharge on fines and penalties was passed, along with an additional annual appropriation of $2 million from this surcharge money to provide additional personnel and equipment.

In the area of corrections, the Department of Corrections inmate population increased during FY 2002 by 2,010 to 29,273. Notwithstanding this growth, new facilities will not be available until FY 2003. Over the next three years another 4,500 beds are planned to be added to the prison system.

With respect to juvenile corrections, the number of juvenile offenders housed in secure care facilities by the Department of Juvenile Corrections decreased from an average of 936 in FY 2001 to 839 in FY 2002. Some of the decline can be attributed to a new program for parole violators that has reduced their incarceration time. The Department continues to enhance public protection by changing the delinquent thinking and behavior of juvenile offenders.

SERVICES PROVIDED BY THE STATE

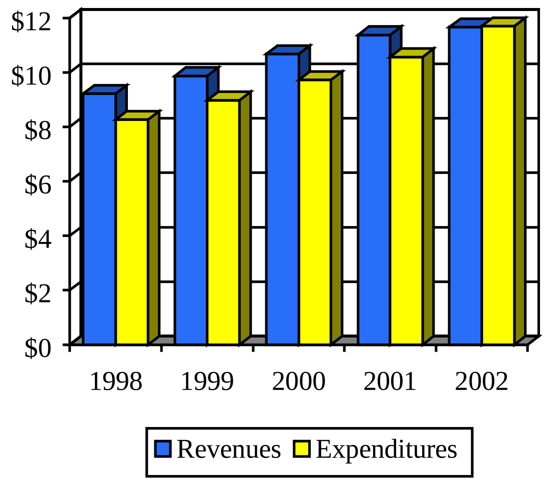
The services provided by the State are administered through various agencies, departments, boards, commissions and institutions of higher learning. These services include: (1) General Government, (2) Health and Welfare, (3) Inspection and Regulation, (4) Education, (5) Protection and Safety, (6) Transportation and (7) Natural Resources.

GENERAL FUND BALANCE

Graph 1 details the General Fund Revenues and Expenditures for the last five fiscal years. This graph does not include transfer amounts relating to other fund types and other financing sources (uses), which affect the ending fund balance.

Graph 1

General Fund Revenues and Expenditures
for last 5 fiscal years
(*Dollars in billions*)

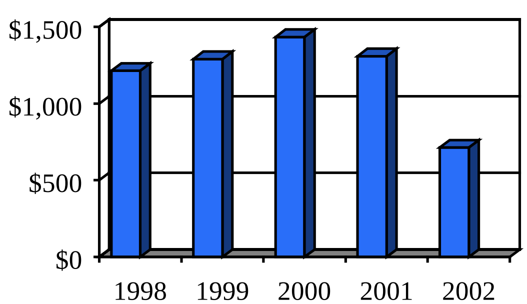


The General Fund ended the June 30, 2002, fiscal year with $560.478 million in unreserved fund balance and a $152.338 million reserved fund balance for a total fund balance of $712.816 million. This compares to the previous year total fund balance of $1.309 billion. Included in the $152.338 million reserved fund balance is $67.7 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of "Rainy Day Fund" established by the Legislature in 1991.

Graph 2 details the General Fund Balance for the last five fiscal years:

Graph 2

General Fund Balance for last 5 fiscal years
(*Dollars in millions*)



BUDGETARY CONTROLS

Budgetary control is maintained through legislative appropriation and the executive branch allotment process. The Governor is required to submit an annual budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature and approval by the Governor. The appropriated funds are controlled by the executive branch through an allotment process. This process allocates the appropriation into quarterly allotments by legal appropriation level. The State also maintains an encumbrance accounting system to further enhance budgetary control. Encumbered amounts generally lapse as of the end of the fiscal year, with the exception of capital outlay items. Capital outlay appropriations and their encumbrances continue from year to year. The State's budgetary policies are explained in detail in the Required Supplementary Information (RSI).

INTERNAL CONTROLS

The State is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management. In the opinion of management, the State's internal controls are adequate to provide reasonable assurance that these objectives are met.

CASH MANAGEMENT

The responsibility for cash management of the State is shared by the Office of the Treasurer (Treasurer) and the General Accounting Office of the Department of Administration, Financial Services Division (GAO). The Treasurer is responsible for the depository, custodial and investment functions of cash. The GAO is responsible for drawing down monies available for State functions and the expenditure or disbursement of those monies.

The State requires that Treasurer's deposits and investments with financial institutions be entirely covered by Federal depository insurance or alternatively collateralized with surety equal to 102% of the deposit or investment. Component units may have collateralization policies that differ from those of the Treasurer.

The Legislature has passed statutes authorizing State investments. Note 2.A. in the Notes to the Financial Statements describes these investments.

The Treasurer deposits receipts in accordance with applicable statutes and invests excess cash of the General Fund and various other funds. All interest, not otherwise apportioned by law, is deposited in the General Fund. Investment earnings for the General Fund totaled $61.2 million for the fiscal year ended June 30, 2002.

PROPRIETARY OPERATIONS

The State's Enterprise Funds are comprised of governmental and quasi-governmental agencies that provide goods and services to the public on a fee for service basis. One of the largest Enterprise Funds is the Lottery Fund. The Lottery Fund generated $295.6 million of operating revenues and $56.0 million of income before contributions and transfers for fiscal year 2002. The Enterprise Funds ended fiscal year 2002 with total ending net assets of $2.964 billion for the Primary Government and $867.0 million for the Component Units. This includes the State Compensation Fund's net assets of $515.0 million restricted for workers' compensation.

The State has Internal Service Funds, which provide a variety of services to State agencies. These include risk management, computer services, telecommunications, transportation services, printing services and other services. The operating revenues for the Internal Service Funds were $530.0 million for fiscal year 2002.

FIDUCIARY FUNDS

Fiduciary Funds are used to account for assets held by the State in a trustee capacity or as an agent for individuals, private organizations and other governments, including the four State Retirement Systems. See Note 5. in the Notes to the Financial Statements for more information on the four State Retirement Systems. The fiduciary activities are not included on the government-wide financial statements because the resources of these funds are not available to support the State's own programs.

RISK MANAGEMENT

The State purchases property and liability coverage whenever available on reasonable terms. The State is insured by an approved property insurer for claims in excess of $3.5 million but less than $345 million and liability claims in excess of $2 million for the Universities and $7 million for all other state agencies but less than $107 million. The State also maintains first dollar aircraft coverage up to $200 million. Other purchased coverages include fidelity and foreign liability. The State's self-insurance fund provides property and liability coverage for claims less than or in excess of this coverage or whenever coverage such as workers' compensation is unavailable on reasonable terms.

The State pays self-insurance losses, defense costs, premiums and administrative costs from an appropriated fund which all of the State's agencies participate in. Total costs (excluding the cost of administering the program) have risen from approximately $15.3 million in fiscal year 1988 to approximately $69.8 million in fiscal year 2002. Yearly appropriations have also increased from approximately $27.7 million in fiscal year 1988 to approximately $81.2 million in fiscal year 2002 to meet rising losses and claims-related expenses. Although there are no assurances, historically the Legislature has appropriated sufficient funds to cover all costs.

INDEPENDENT AUDIT

In compliance with State statute, an annual financial audit of the "State Entity" is completed each year by the State of Arizona, Office of the Auditor General in conjunction with other audit firms. Their audit was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Their report on the basic financial statements has been included in the financial section of this report. In addition, ARS §41-1279.03 requires at least a biennial single audit by the Office of the Auditor General. The Single Audit will be issued as a separate report at a later date.

ACKNOWLEDGMENTS

We wish to express our sincere appreciation to the many individuals whose dedicated efforts have made this report possible. The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each State agency, board, commission, institution of higher education and all other organizations within the reporting entity.

Betsey Bayless
Director

D. Clark Partridge
State Comptroller